

**STATE OF WASHINGTON  
OFFICE OF THE INSURANCE  
COMMISSIONER**



**FINANCIAL EXAMINATION  
OF  
WASHINGTON CASUALTY COMPANY  
IN REHABILITATION  
ISSAQUAH, WASHINGTON**

**NAIC CODE 42510  
DECEMBER 31, 2004**

Participating State:  
Washington

**Order No. G 06-18  
Washington Casualty Company  
In Rehabilitation  
Exhibit A**

SALUTATION

Seattle, Washington  
March 30, 2006

The Honorable Alfred W. Gross, Commissioner  
Chair, NAIC Financial Condition (E) Committee  
State Corporation Commission  
Bureau of Insurance  
Commonwealth of Virginia  
PO Box 1157  
Richmond, VA 23218

The Honorable Gary Smith, Director  
Idaho Department of Insurance  
Secretary, Western Zone  
700 West State Street, 3<sup>rd</sup> Floor  
Boise, ID 83720-0043

The Honorable Mike Kreidler, Commissioner  
Washington State Office of the Insurance Commissioner (OIC)  
302-14<sup>th</sup> Avenue SW  
Olympia, WA 98504

Dear Commissioners and Director:

In accordance with your instructions and in compliance with the statutory requirements of RCW 48.03.010, an examination was made of the corporate affairs and financial records of

Washington Casualty Company in Rehabilitation  
of  
Issaquah, Washington

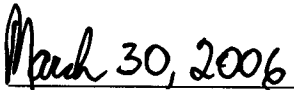
hereinafter referred to as "WCC" or "the Company," at its home office located at 6520 226<sup>th</sup> Place SE, Suite 200, Issaquah, Washington. The following report on the examination is respectfully submitted showing the condition of the Company as of December 31, 2004.

CHIEF EXAMINER'S AFFIDAVIT

I hereby certify I have read the attached Report of the Financial Examination of the Washington Casualty Company, in Rehabilitation, of Issaquah, Washington. This report shows the financial condition and related corporate matters as of December 31, 2004.

A handwritten signature in black ink, reading "Patrick H. McNaughton", written over a horizontal line.

Patrick H. McNaughton  
Chief Examiner

A handwritten date in black ink, reading "March 30, 2006", written over a horizontal line.

Date

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## **SCOPE OF THE EXAMINATION**

This examination covers the period January 1, 2003 through December 31, 2004 and comprises a comprehensive review of the books and records of the Company. The examination followed the statutory requirements contained in the Washington Administrative Code (WAC), the Revised Code of Washington (RCW), and the guidelines recommended by the National Association of Insurance Commissioners (NAIC) Financial Condition Examiners Handbook (FCEH). The examination included identification and disposition of material transactions and events occurring subsequent to the date of examination that were noted during the examination.

Corporate records, external reference materials, and various aspects of the Company's operating procedures and financial records were reviewed and tested during the course of this examination and are commented upon in the following sections of this report. In addition, the Company's certified public accountant's (CPA's) work papers were reviewed and utilized, where possible, to facilitate efficiency in the examination.

## **COMMENTS AND RECOMMENDATIONS**

The examiners reviewed the Company's filed 2004 NAIC Annual Statement as part of the statutory examination. This review was performed to determine if the Company completed the NAIC Annual Statement in accordance with the NAIC Annual Statement Instructions and to determine if the Company's accounts and records were prepared and maintained in accordance with the NAIC Statements of Statutory Accounting Principles (SSAP) as contained in the Accounting Practices and Procedures Manual (AP&P).

The following summarizes the exceptions noted while performing this review.

### **1. Control Over Investment Activities**

There is no Board of Directors (BOD) to "authorize or approve" investment transactions as required by RCW 48.13.340, since the BOD was dissolved upon entering rehabilitation. The CFO formulates and executes all investments transactions without prior approval or review. A periodic report is sent to the Deputy Receiver, summarizing all transactions completed since the last report. There are no independent compensating controls in place prior to execution. In addition, there is no written investment authorization record, signed by an officer or other competent party, as is normally required by RCW 48.13.350(1).

**It is recommended that the Deputy Receiver perform the control function of authorizing or approving investment transactions as required by RCW 48.13.340. It is also recommended that the Company maintain a permanent written record of these authorizations, signed by the Deputy Receiver as required by RCW 48.13.350 (1).**

## **2. Controls Over Cash Disbursements**

According to the Deputy Receiver's check authorization policy, two authorized signers are required for checks greater than \$100,000. Six claim checks exceeding \$100,000 were found containing only one authorized signature. Also, one duplicate payment of \$300 was observed during our disbursement review.

**In view of the above material deviations from existing policies, it is recommended that the Company establish stronger controls over all check issuance.**

## **3. Improper Closing of General Ledger Accounts**

The general ledger accounts were improperly closed on December 22, 2004, so some 2004 transactions were omitted from that year. For example, certain 2004 case reserve increases could not be recorded until 2005. As a result, three 2004 claims, aggregating to \$800,000, with a net surplus effect of \$250,000, were recorded in 2005. This is not in compliance with SSAP No. 5, paragraph 4, which requires accrual of such liabilities.

No adjustment is being proposed for the omitted claims, since the overall unpaid loss reserves are adequate (see the "Unpaid Loss and Loss Adjustment Expenses" section of this report). However, in the future, the Company should either keep its accounts open until year-end or make arrangements to ensure that all significant transactions can be entered or accrued through a post-closing procedure.

**It is recommended that the Company record all liabilities, as required by SSAP No. 5, paragraph 4. It is also recommended that it file an accurate NAIC Annual Statement of its financial condition, transactions, and affairs and accrue for all loss reserves on a timely basis in accordance with RCW 48.05.250. WCC should also properly account for all transactions in the appropriate year, in accordance with established and accepted accounting principles.**

## **4. NAIC Annual Statement Errors**

The Company generally writes policies on a claims-made basis. However, it also sells Extended Reporting Endorsements (ERE), which convert claims-made policies to an occurrence basis. In the NAIC Annual Statement, manual reallocation is needed to distinguish claims-made losses from those which qualify as occurrence transactions, as required by the NAIC Annual Statement Instructions and as defined in SSAP No. 65, paragraph 3 a and b. In the 2002 through 2004 NAIC Annual Statements, the Company did not manually reallocate facility and hospital ERE claims to the appropriate policy year on Schedule P, Part 1F. Facility claims were reported using the date of notice (claims made) rather than the policy year date (occurrence).

**It is recommended that the Company comply with all SSAP's and with WAC 284-07-050(2) which requires adherence to the appropriate NAIC Annual Statement Instructions and the SSAP. It is further recommended that WCC comply with RCW 48.05.250 by filing with the insurance commissioner an accurate NAIC Annual Statement of its financial condition, transactions, and affairs.**

#### **5. Policy Language Deficiencies**

In 1990, the Company had issued a Directors and Officers (D&O) policy which contained unnecessarily broad language. This resulted in a claim which had not been foreseen in the corresponding premium calculation for that policy form.

WCC continued using the same policy language in its D&O policies, and, in 2004, a different hospital brought a new D&O claim under a policy issued in 2003. This resulted in a second settlement, for \$422,000. Subsequently, \$115,000 was recovered from the responsible parties and the policy form was corrected to eliminate the unintended coverage.

**Since it is possible that other policy forms contain language which affords unintended coverage, it is recommended that WCC review all its policy forms to determine whether any other unnecessarily broad language has been revealed by prior claim filings.**

#### **6. Reinsurance Credits**

The Company does not have collateral or letters of credit (LOC) for its reinsurance cessions to unauthorized companies.

**It is recommended that the Company request appropriate letters of credit from all unauthorized reinsurers.**

### **COMPANY PROFILE**

#### **Company History**

WCC was incorporated under Washington law on June 21, 1990 and commenced operations on October 1, 1990. The Company was formed as a wholly-owned subsidiary of the Northwest Health Insurance Services (NHIS). WCC assumed the claims-made business written by NHIS, which had provided hospital liability insurance to Washington hospitals since 1976, when it was formed as the Washington Hospital Liability Insurance Fund.

On March 6, 2003, the Superior Court of Thurston County, Washington, entered an Order of Rehabilitation and Appointment of Receiver, placing WCC into rehabilitation and appointing a receiver.

## **Capitalization**

WCC has 300,000 shares of common capital stock issued and outstanding at a par value of \$10 per share. All shares were previously issued to and held by NHIS. NHIS was liquidated by Court order on May 29, 2004. All NHIS assets, including 100% of WCC's capital stock, were transferred to WCC at fair value. This transfer resulted in a net charge of \$664,511 to WCC's surplus and the NHIS stock is now held at zero value.

## **Territory and Plan of Operation**

After the Company went into receivership, several states suspended the Company's Certificates of Authority. The Oregon, Nevada, Montana and Idaho certificates were returned to the states. Presently, the Company writes new business only in the state of Washington, although it is permitted to renew existing accounts in the state of Idaho.

## **Growth of Company**

The Company's growth, as reported in its filed NAIC Annual Statements, is illustrated below.

	<u><b>2004</b></u>	<u><b>2003</b></u>
Total admitted assets	\$25,833,334	\$29,255,733
Total liabilities	<u>33,863,596</u>	<u>38,007,920</u>
Total capital and surplus	<u><u>(\$8,030,262)</u></u>	<u><u>(\$8,752,187)</u></u>
Total revenue	\$6,276,489	\$8,396,554
Losses incurred	2,441,552	8,716,364
Loss expenses incurred	3,613,460	2,400,588
Other underwriting expenses incurred	2,297,702	4,006,955
Net investment gain	488,396	(333,511)
Other income	<u>46,485</u>	<u>20,664</u>
Net income or (loss)	<u><u>(\$1,541,344)</u></u>	<u><u>(\$7,040,200)</u></u>

## **AFFILIATED COMPANIES**

### **Ownership and Intercompany Contracts**

The parent company, NHIS, was liquidated by Court order on May 29, 2004. All NHIS assets, including 100 % of WCC's capital stock, were transferred to WCC at their fair



value and the remaining balance was written off. All intercompany arrangements were eliminated as a result of the liquidation.

## **MANAGEMENT AND CONTROL**

### **Board of Directors (BOD) and Committees**

The BOD and any committees were dissolved after the Company was placed into rehabilitation by the OIC.

### **Officers**

As of December 31, 2004, the Company officers were:

<b><u>Name</u></b>	<b><u>Title</u></b>
John B. Woodall	Deputy Receiver
Marc A. Mrkvicka	CFO and Treasurer
Mark Carroll Hannon III	Vice President – Underwriting, and Secretary
Barbara Ann McCarthy	Vice President - Claims

### **Conflict of Interest**

WCC has a policy statement and questionnaire to disclose conflicts of interest, which all directors, officers and key employees are required to sign.

### **Fidelity Bond and Other Insurance**

The fidelity bond and other insurance were reviewed and the Company has the normal types of property and liability coverage carried by insurance companies. Additionally, the WCC's fidelity bond meets the NAIC's minimum guidelines for a company of its size.

### **Officers', Employees', and Agents' Welfare and Pension Plans**

The Company has no defined benefit plan. Company employees are covered by a qualified defined contribution [401(K)] plan and a discretionary profit sharing plan, similar to that which was originally sponsored by the parent company.

## **CORPORATE RECORDS**

The corporate records were reviewed for the period under examination.

WCC's Bylaws were suspended after it went into rehabilitation and the Company does not have to follow the Bylaws until it emerges from reorganization.

The latest restated Articles of Incorporation are dated November 15, 2002 and, among other things, state that the Company is located at the former address in Bellevue, Washington. As of the December 31, 2004 examination date, the Company has been at its Issaquah address for about two years.

### **UNPAID LOSSES AND LOSS ADJUSTMENT EXPENSES**

The reserves carried by the Company for its unpaid losses and loss adjustment expenses were \$23,073,015 and \$8,139,067, respectively, as of December 31, 2004. These reserves were reviewed by the OIC actuarial staff, utilizing loss and loss adjustment expense development data as of September 30, 2004 and an actuarial report as of December 31, 2004, all of which were received directly from WCC's consulting actuary. Additional information was also obtained directly from WCC.

As a result of its review, the OIC estimates that the Company's reserves for losses and loss adjustment expenses as of December 31, 2004, on a net basis, are within a range of reasonable estimates.

Therefore, the loss and loss adjustment expense reserves are accepted as they appear in the Company's NAIC Annual Statement.

### **REINSURANCE**

Effective December 1, 2004, the Company entered into a three-year excess of loss program which reinsures \$500,000 per claim, plus pro rata expenses, in excess of \$500,000 retained by the Company. The maximum loss recovery, including expenses, is limited to 250% of premiums ceded in any one year, not to exceed 200% of the ceded premiums for the full three-year period. On February 1, 2005, the Company secured an additional one-year cover for \$1,000,000, including expenses, in excess of \$1,000,000 per claim, with the maximum recovery limited to 285% of ceded premium, or \$5,000,000. Policy limits can be issued which exceed the Company's primary layers, but they would be subject to separate excess reinsurance.

From July 1, 2003 through November 30, 2004, WCC wrote without reinsurance and retained \$1 million per claim, arranging for another carrier to provide hospital and facilities coverage exceeding \$1 million.

Under Extended Reporting Endorsements, certain treaties remain in force for some policies written prior to July 1, 2003. Under these EREs, each covered claim in excess of

\$250,000 (physicians) or \$500,000 (hospitals and facilities) is covered up to a maximum of \$10,000,000, subject to certain individual maximum recoveries in each treaty.

### **STATUTORY DEPOSITS**

The Company has the following statutory deposits:

<u>State</u>	<u>Par Value</u>	<u>Market Value</u>	<u>Statement Value</u>
Washington	\$1,500,000	\$1,530,770	\$1,530,770
Nevada	\$200,000	\$204,205	\$204,205

### **ACCOUNTING RECORDS AND INFORMATIONS SYSTEMS**

The Company maintains its accounting records on a Statutory Accounting Principles (SAP) basis for NAIC Annual Statement reporting. WCC's 2003 financial statements were audited by a certified public accounting firm and received an unqualified opinion.

The management of Washington Casualty Company, in Rehabilitation (WCC), is sufficiently knowledgeable of the IS process. Systems development, acquisition and maintenance controls were evaluated to gain assurance that appropriate controls are in place.

Operations and application controls were reviewed to determine the type of hardware installed; operating systems and proprietary software in use; back up and recovery facilities employed; and the controls exercised to maintain data security. The Company has sufficient internal controls in place to monitor system activity and processes.

WCC has a formal, written Disaster Recover Plan and a Business Contingency Plan that addresses the continuation of all significant business activities, including financial functions, telecommunication services and data processing services, in the event of a disruption of normal business activities, as recommended by NAIC Guidelines.

### **SUBSEQUENT EVENTS**

There were no significant subsequent events.

### **FOLLOW UP ON PREVIOUS EXAMINATION FINDINGS**

There were no previous report instructions or comments.

## **FINANCIAL STATEMENTS**

Assets, Liabilities, Surplus and Other Funds

Summary of Operations

Reconciliation of Surplus for the Period Since the Last Examination

Analysis of Changes in the Financial Statements as a Result of the  
Examination

**WASHINGTON CASUALTY COMPANY IN REHABILITATION**  
**ASSETS, LIABILITIES, SURPLUS AND OTHER FUNDS**  
**DECEMBER 31, 2004**

	<u>BALANCE PER</u> <u>COMPANY</u>	<u>REF</u>	<u>EXAM</u> <u>ADJ</u>	<u>BALANCE PER</u> <u>EXAM</u>
<u>Assets</u>				
Bonds	\$18,377,136			\$18,377,136
Common Stock	2,697,542			2,697,542
Cash and short term investments	2,050,539			2,050,539
Subtotals, cash and invested assets	<u>23,125,217</u>			<u>23,125,217</u>
Investment income due and accrued	133,547			133,547
Premiums and considerations:				
Uncollected premiums and agents' balance				
In course of collection	17,032			17,032
Deferred premiums	2,189,328			2,189,328
Amounts recoverable from reinsurers	318,061			318,061
EDP equipment	50,149			50,149
Total Assets	<u>\$25,833,334</u>		<u>\$0</u>	<u>\$25,833,334</u>
<u>Liabilities</u>				
Losses	\$23,073,015			\$23,073,015
Loss adjustment expenses	8,139,067			8,139,067
Other expenses	119,406			119,406
Unearned premiums	1,706,760			1,706,760
Ceded reinsurance premiums payable	714,793			714,793
Provisions for reinsurance	62,000			62,000
Aggregate write-ins for liabilities	48,555			48,555
Total Liabilities	<u>\$33,863,596</u>		<u>\$0</u>	<u>33,863,596</u>
<u>SURPLUS AND OTHER FUNDS</u>				
Common capital stock	\$3,000,000			\$3,000,000
Gross Paid in and contributed	13,050,227			13,050,227
Unassigned funds (surplus)	<u>(24,080,489)</u>			<u>(24,080,489)</u>
Capital and surplus	<u>(8,030,262)</u>		<u>0</u>	<u>(8,030,262)</u>
Total Liabilities, Surplus and Other Funds	<u>\$25,833,334</u>		<u>\$0</u>	<u>\$25,833,334</u>

**WASHINGTON CASUALTY COMPANY IN REHABILITATION**  
**STATEMENT OF INCOME**  
**YEAR ENDED**  
**DECEMBER 31, 2004**

	<u>BALANCE</u> <u>PER COMPANY</u>	<u>REF</u>	<u>EXAM</u> <u>ADJ</u>	<u>BALANCE PER</u> <u>EXAMINATION</u>
<u>UNDERWRITING INCOME</u>				
Premiums earned	\$6,276,489			\$6,276,489
<u>DEDUCTIONS</u>				
Losses incurred	2,441,552			2,441,552
Loss expenses incurred	3,613,460			3,613,460
Other underwriting expenses incurred	2,297,702			2,297,702
Total underwriting deductions	8,352,714			8,352,714
Net Underwriting gain (loss)	<u>(2,076,225)</u>			<u>(2,076,225)</u>
<u>INVESTMENT INCOME</u>				
Net investment income	464,666			464,666
Net realized capital gains	23,730			23,730
Net investment gain (loss)	<u>488,396</u>			<u>488,396</u>
<u>OTHER INCOME</u>				
Aggregate write-ins for miscellaneous income	46,485			46,485
Total other income	<u>46,485</u>			<u>46,485</u>
Net income before dividends to policyholders and before federal income taxes	(1,541,344)			(1,541,344)
Net income, after dividends to policholders but before federal income taxes	(1,541,344)			(1,541,344)
Federal income taxes incurred	0			0
Net Income	<u>(\$1,541,344)</u>			<u>(\$1,541,344)</u>
<u>CAPITAL AND SURPLUS</u>				
Surplus, December 31, 2003	(\$8,752,188)			(\$8,752,188)
Net Income	(1,541,344)			(1,541,344)
Change in unrealized capital gains and losses	305,692			305,692
Change in nonadmitted assets	1,242,208			1,242,208
Change in provision for reinsurance	(48,627)			(48,627)
Surplus adjustments:				0
Paid in	1,428,508			1,428,508
Aggregate write-ins for gains and losses in surplus	(664,511)			(664,511)
Change in surplus	721,926			721,926
Surplus, December 31, 2004	<u>(\$8,030,262)</u>			<u>(\$8,030,262)</u>

**WASHINGTON CASUALTY COMPANY IN REHABILITATION  
RECONCILIATION OF SURPLUS  
DURING THE REHABILITATION PERIOD**

	<u><b>2004</b></u>	<u><b>2003</b></u>
Capital and Surplus, December 31, Previous Year	(\$8,752,188)	(\$3,996,394)
Net income	(1,541,344)	(7,040,200)
Change in net unrealized capital gains (losses)	305,692	1,794,325
Change in net deferred income tax		(429,805)
Change in non-admitted assets and related item	1,242,208	(1,423,593)
Change in provision for reinsurance	(48,627)	(11,581)
Surplus adjustments paid in	1,428,508	2,355,060
Other	(664,511)	
Net change in capital and surplus for the year	721,926	(4,755,794)
Ending Capital and Surplus	<u>(\$8,030,262)</u>	<u>(\$8,752,188)</u>

**WASHINGTON CASUALTY COMPANY IN REHABILITATION**  
**ANALYSIS OF CHANGES IN THE FINANCIAL STATEMENTS RESULTING FROM THE EXAMINATION**  
**DECEMBER 31, 2004**

	<u>PER</u> <u>COMPANY</u>	<u>PER</u> <u>EXAMINATION</u>	<u>EXAMINATION</u> <u>ADJUSTMENT</u> <u>REFERENCE</u>	<u>INCREASE</u> <u>(DECREASE)</u> <u>IN SURPLUS</u>	<u>TOTALS</u>
<b>Capital and Surplus, December 31, 2004 - Per Annual Statement</b>					<b>(\$8,030,262)</b>
<b><u>ASSETS</u></b>					
Assets	\$25,833,334	\$25,833,334		\$0	0
<b><u>LIABILITIES</u></b>					
Liabilities	\$25,833,334	\$25,833,334		\$0	0
<b>Capital and Surplus, December 31, 2004 - Per Examination</b>					<b>(\$8,030,262)</b>



## **NOTES TO THE FINANCIAL STATEMENTS**

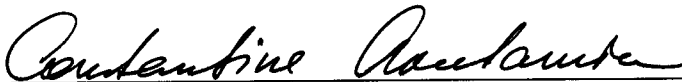
- 1) Until June 30, 2005, the Company collected capital assessments from policyholders under a state of Washington Solicitation Permit. Contributions collected during 2004 were \$1,428,508 and the total contributions through December 31, 2004 were \$5,404,227.
- 2) The parent company, NHIS, was liquidated by Court order on May 29, 2004. All NHIS assets, including 100 % of WCC's capital stock, were transferred to WCC. The assets were transferred at their fair value and the remaining balance was written off.
- 3) The Company received the following special consents, permitted practices or orders from the state of Washington:
  - a. Permission to hold as assets both the issued shares of its own stock and the data processing system received from NHIS, and to depreciate the system over five years.
  - b. Permission to revalue its parent's net assets to their fair value by a direct charge to surplus, without going through the Statement of Income.
  - c. Consent for a one-year suspension from filing an audit report for 2004, conditional upon a full-scope financial examination of that year by OIC examiners.

### **ACKNOWLEDGEMENT**

The cooperation and assistance of the officers and employees of the Company during the examination are hereby acknowledged.

In addition to the undersigned, John Gaynard, CFE, CPCU, CPA; Richard Bologna, Certified Fraud Examiner; Michael V. Jordan, CFE, CPA, MHP, Assistant Chief Examiner; John Jacobson, AFE, AES, and Lee Barclay, FCAS, MAAA, all from the Washington State Office of the Insurance Commissioner, participated in the examination and the preparation of this report.

Respectfully submitted,

A handwritten signature in cursive script, reading "Constantine Arustamian", is written over a horizontal line.

Constantine Arustamian, CPA, CFE

Examiner in Charge

Washington State Office of the Insurance Commissioner

**AFFIDAVIT**

State of Washington           )  
  ) ss  
County of King                )

Constantine Arustamian, being duly sworn, deposes and says that the foregoing report subscribed by him is true to the best of his knowledge and belief.

*Constantine Arustamian*

Constantine Arustamian, CPA, CFE

Examiner in Charge

Washington State Office of the Insurance Commissioner

Subscribed and sworn to before me on this 30<sup>th</sup> day of March, 2006.

*Colleen Jansen*

Notary Public in and for the  
State of Washington

